Bayley v. Commissioner, 69 T. C. 234 (1977)

Stock received as compensation for services, subject to restrictions significantly affecting its value, must be treated as restricted stock under IRS regulations, not as a second class of stock.

Summary

Alan J. Bayley received 5,000 shares of General Recorded Tape, Inc. (GRT) stock as compensation, subject to promotional restrictions imposed by the California Commissioner of Corporations. These restrictions significantly affected the stock's value, which was contested in a tax dispute with the IRS. The Tax Court held that the stock was restricted for tax purposes and that all restrictions lapsed in 1968, resulting in ordinary income for Bayley. The decision clarified that securities law restrictions can be considered significant under IRS regulations, impacting how such stock is valued for tax purposes.

Facts

In 1966, Alan J. Bayley received 5,000 shares of GRT stock as compensation for his services to the company. These shares were issued under a permit from the California Commissioner of Corporations, which imposed promotional restrictions including escrow, and limitations on liquidation, dividend, and voting rights. The value of unrestricted GRT stock was $10 per share, while the restricted stock was valued at $0. 509 per share. In 1968, the Commissioner issued an Order Terminating Escrow and an Amendment to Permit, which Bayley and his attorney interpreted as removing all restrictions.

Procedural History

The IRS determined a tax deficiency for 1968, asserting that Bayley realized ordinary income from the GRT stock when restrictions lapsed. Bayley petitioned the Tax Court, arguing that the stock was a second class of stock and that the restrictions were not significant for tax purposes. The Tax Court found in favor of the Commissioner, ruling that the stock was subject to significant restrictions and that those restrictions lapsed in 1968.

Issue(s)

1. Whether the stock issued to Bayley was subject to restrictions significantly affecting its value.
2. Whether such restrictions were removed, or ceased to have a significant effect on the stock's value during 1968.

Holding

1. Yes, because the stock was subject to promotional restrictions that significantly

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reduced its market value compared to unrestricted stock.
2. Yes, because the Order Terminating Escrow and the Amendment to Permit effectively removed all significant restrictions in 1968.

Court’s Reasoning

The court applied IRS regulations 1. 61-2(d)(5) and 1. 421-6(d)(2)(i), which require that property transferred as compensation, subject to restrictions significantly affecting value, be treated as restricted stock. The court distinguished this case from Frank v. Commissioner, where securities law restrictions did not significantly affect value. The court reasoned that the promotional restrictions on Bayley’s stock, imposed by the California Commissioner of Corporations, did significantly affect its value due to the large difference in market prices between restricted and unrestricted shares. The court also noted that the Commissioner intended to terminate all restrictions in 1968, as evidenced by the Order and Amendment, and the lack of other enforcement mechanisms post-escrow termination.

Practical Implications

This decision impacts how stock compensation subject to securities law restrictions is treated for tax purposes. It clarifies that such restrictions can be significant under IRS regulations, requiring the stock’s value to be determined without regard to the restrictions for tax purposes. Practitioners must consider whether stock restrictions significantly affect value, even if imposed by government agencies. The ruling also suggests that the effective termination of restrictions, even if inartfully done, can result in immediate tax consequences. This case has been cited in subsequent tax disputes involving restricted stock, influencing the analysis of when restrictions lapse and the resulting tax treatment.

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